INVESTMENT

The fog clearing

Stuart Anderson considers the current efforts to remove the opaque nature of investment costs and improve transparency

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The costs incurred by investment managers on behalf of clients, including pension funds, are often much greater than the headline investment management fee. The latter is used to remunerate the fund manager but does not include costs incurred by that manager on behalf of investors.

A range of factors, including custodian fees, trading commissions, bid-offer spreads and even the market pricing impact of large trades all contribute to the full costs incurred by investors. The pressure has been on pension funds to report on the impact of these costs for some time.

Requirements vary around Europe. In the Netherlands, for example, pension schemes have since 2017 had to include details of transaction costs in their annual reports. In the UK, meanwhile, the chairs of the trustee boards of defined contribution (DC) schemes have to produce an annual 'Chair's Statement', which includes a section on 'value for members' – which includes the full costs of investment management.

The UK government recently released a white paper that proposes extending the requirement to produce a Chair's Statement to defined benefit (DB) schemes.

There has to-date been a problem with all this – regulations requiring pension funds to account for the full cost of investment management have not historically been matched by a requirement for fund managers to provide this information. With the introduction across the European Union of MiFID II on 3 January 2018 this is now changing, although it is likely to be some time before consistent formats and standards for reporting are developed.

Explicit and implicit costs

Sparrows Capital investment manager Mark Northway summarises the problem: "Initial MiFID II cost reporting by investment managers has been inconsistent both in terms of methodology and outcome, and it will be some time before the benefits of MiFID II cost transparency are realised. In particular, the industry is still grappling with reporting implicit transaction costs, which are notoriously difficult to determine.

"At this point, the best we can say is that the initial data provides pension funds with a useful means of ranking strategies by their execution cost."

There are two key issues: the way figures are reported by fund managers and the way they are interpreted by pension funds and their advisers. When it comes to what is reported, Northway believes that "more is more".

He says: "Certain components of cost, notably management fee, custody, direct fund costs and trade commissions, are easily and accurately calculated by managers and serve as robust comparators with competing products. Other components, including implicit transaction costs such as bid/offer, the price impact of larger trades and arguably the effect of swing pricing and dilution clauses, can only ever be estimates, and those estimates will vary wildly between managers.

"The value of a single figure aggregating initial charges, redemption charges, management fees, stock lending charges, custody, audit, legal, brokerage, taxes, and implicit transaction costs is minimal. The benefit is in the detail."

What does it mean?

While detail may be important for sound decision making, schemes are not currently used to dealing with, and assessing, this information. Mercer director of consulting Brian Henderson says: "The problem at first will be that all of this information will be reported by the fund managers but we don't have any aggregate or benchmark numbers against which to judge whether costs look too high or low.

"All of this comes out in April. It will then take us months to work out what to do with all of this information and what it means."

This is primarily a problem of data analysis and interpretation, and technology will doubtless play its part. However, software firms are already developing systems that they say will address this.

In the UK, financial services regulator the Financial Conduct Authority has been carrying out its own work on cost transparency, and has set up an Institutional Disclosure Working Group (IDWG) to lead its efforts in this area. According to the UK-based Pensions and Lifetime Savings Association (PLSA) policy lead – investment and DB Caroline Escott: "One key focus for the IDWG is to disseminate templates amongst investment consultants and trustees – the PLSA will be supporting the IDWG with this task.

"It's important that the messaging around costs is carefully considered, to avoid an outcome where trustees are encouraged to think that the lowest cost product or approach automatically represents the best option. We must ensure that conversations and communication around this topic encourage schemes to think about the value they gain from their investments, rather than simply the cost they are paying."

Making informed decisions

There is a broad recognition in the industry that fees are not an evil in and of themselves, and that in many cases 'cheaper' may not equal better. However, there is also an understanding that without transparency it is impossible to make a judgment on whether or not fees are justified.

UK Pensions Management Institute vice president and KGC Associates director Lesley Carline says: "There are charges that just aren't known about – it's not necessarily that they aren't warranted but simply that trustees don't know about them."

While MiFID II will lead to disclosure of previously 'hidden' fees, the important thing will be what pension schemes do with this information. "The onus will be on trustees to review their investment management agreements, and to speak to their investment consultants and managers about this," Carline continues.

"There are those who believe that many of these fees – for instance investment research – are a cost of operation and shouldn't affect performance. You could argue, for example, that if active managers cut back on research it will affect their performance.

"The main point, though, is that if trustees don't know hidden fees they can't make an informed judgment."

Like-for like comparisons

Like-for-like comparison will be crucial as schemes begin analysing cost data. Hymans Robertson partner and senior investment consultant Rona Train says: "If you are comparing two passive funds then it's probably fairly straightforward.

"But what about a blended fund that might have a passive element and a couple of different active ones? How do you compare that to another blend?

"Like-for-like comparisons will be critical."

Pension scheme trustees and managers are, of course, informed consumers, and have training available to them to help them make the best decisions. The same is not necessarily true of most members of defined contribution schemes.

It will, therefore, be vital that information on fund costs is communicated to members in a way that does not lead to poor decisions.

Train continues: "This data could potentially skew member behaviour. Members are going to get this information on transaction costs and there's a danger it could lead to inappropriate decisions.

"For example they could look at a property fund and think, 'the transaction costs look high on that, I'll invest in this equity fund instead'. So there's a danger that it could lead members to do things that might not be right for them."

Who pays for it?

While there is a general acceptance in the industry that full cost disclosure will help improve the competitive landscape, there is also an element of fear that full fee transparency could prove a Pyrrhic victory for pension funds in terms of cost savings.

Henderson says: "We are, of course, in favour of transparency on costs. There is a question, though, with regard to who pays for the new reporting systems that the fund managers are having to implement, and whether that actually ends up feeding through into higher fees for clients." ■